

REDACTED

REVISED ADDITIONAL DIRECT AND REBUTTAL TESTIMONY

OF

DAVID REARDEN

POLICY PROGRAM

ENERGY DIVISION

ILLINOIS COMMERCE COMMISSION

NORTH SHORE GAS COMPANY

DOCKET NO. 01-0706

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1 **1. Introduction.**

2 **Q: Please state your name, job title and business address.**

3 **A:** My name is David Rearden and I am a Senior Economist on the Staff of  
4 the Illinois Commerce Commission (“Staff” and “Commission”) in the  
5 Policy Program. My business address is 527 East Capitol Avenue,  
6 Springfield, Illinois 62701.

7 **Q: Are you the same David Rearden that filed direct testimony?**

8 **A:** Yes.

9 **Q: What’s the purpose of this testimony?**

10 **A:** I respond to the rebuttal testimony of David Wear, Tom Zack, and Frank  
11 Graves. In addition, I discuss new material that impacts previous issues  
12 as well and raises new issues, which are not readily segregated in my  
13 testimony.

14 **Q: Please outline your testimony?**

15 **A:** First, I discuss the additional documents that Staff obtained through  
16 discovery after North Shore filed rebuttal discovery. These additional  
17 documents show that a strategic partnership existed between Peoples  
18 Energy Corporation (“PEC”) and Enron (specifically the subsidiary entitled  
19 Enron North America (“ENA”). I contend that this strategic partnership led  
20 to Peoples Gas and North Shore entering into the high priced Gas  
21 Purchase and Agency Agreement (“GPAA”). I evaluate the GPAA’s

22 prudence and respond to the Company's witnesses with respect to the  
23 GPAA discussion in my direct testimony. I also find that the Company's  
24 response to Staff's discussion of its usage of Manlove field in December  
25 2000 to be inadequate, and I introduce a disallowance to measure the  
26 increased costs of the imprudent Manlove usage. I repeat my call for a  
27 management audit of the Company's gas purchasing practices, gas  
28 storage operations and storage activities. Finally, I discuss the  
29 adjustments that the GCPI propose to compensate ratepayers for North  
30 Shore's failure to hedge its gas purchases during the winter of 2000-2001.

31 **2. Prudence issues.**

32 **Q: In a PGA reconciliation docket, what is your understanding of which**  
33 **party has the burden of proof?**

34 **A:** Although I am not an attorney, it is my understanding the Company has  
35 the burden of proof Company's gas purchasing practices, gas storage  
36 operations and storage activities. To demonstrate the prudence of North  
37 Shore's actions in any aspect of its dealings in fiscal year 2001, the  
38 Company should be able to inform the Commission through testimony  
39 what it knew and when it knew it.

40 **Q: Did the additional discovery provide additional information on the**  
41 **GPAA and its prudence?**

42 **A:** Yes. An individual at PEC analyzed both the value of the GPAA to Enron  
43 as well as its effects on the cost of gas to ratepayers. It was called the

44 Aruba analysis.<sup>1</sup> For whatever reason, North Shore declined to share that  
45 analysis with Staff. However, there is some evidence that it was  
46 presented to utility personnel prior to the GPAA's signing.<sup>2</sup> I discuss the  
47 Aruba analysis further below. In any event, no part of it was provided to  
48 Staff prior to re-opening of discovery on February 10, 2004.

49 **Q: Has the Company shown that the GPAA was prudent?**

50 **A:** No. In my Direct Testimony, I conducted an analysis of the GPAA, and I  
51 stated there that it was imprudent for the Company not to have formally  
52 analyzed its effects on the ratepayer. In effect, I attempted to conduct my  
53 own Aruba analysis using what I perceived to be the same information set  
54 the Company had when it made its decision. I based my calculations upon  
55 data and other information provided to me by the Company.

56 **Q: Has the Company met its burden of proof for all its other costs?**

57 **A:** No.

58 **Q: Does Staff believe that the Company is obligated to pick the best**  
59 **alternative for ratepayers using the information and its evaluation of**  
60 **the alternatives?**

61 **A:** Yes.

62 **Q: Company witness Zack provides an example of 'reasonable' as the**  
63 **foundation for prudent. It features the Company's decision to buy a**

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<sup>1</sup> The strategic partnership with Enron was called Project Aruba.

<sup>2</sup> See Deposition of Roy Rodriguez at pp.

64           **loaf of bread for \$1 when the same loaf is available down the street**  
65           **for 99¢. How does Staff respond to his example?**

66    **A:**    The Company's decision to enter into the GPAA is not like buying a loaf of  
67           bread. A more apt analogy is the Company buying millions of loaves  
68           years in advance. In that case, it makes sense for the Company to shop  
69           extensively for the best value. A one percent price difference on a large  
70           contract could be worth a lot of money.

71           Further, if there is no difference in the cost to acquire the lower priced loaf  
72           and it is of the same quality and the Company knew or should have known  
73           about the lower priced loaf, then Staff views the decision not to buy the  
74           lower priced loaf as imprudent. It is not reasonable for customers to be  
75           expected to pay more than is necessary for an identical product.

76    **3. Affiliate issues and the Enron partnership.**

77    **Q:**    **Why is Staff filing this testimony as additional direct and rebuttal**  
78           **rather than just rebuttal?**

79    **A:**    As Staff was developing its reply to Company rebuttal; some Enron  
80           documents on a FERC web site became the subject of discovery, since  
81           those documents provided information about North Shore. The ALJ  
82           suspended the procedural schedule to allow further discovery on this  
83           material. Staff and the GCPI issued data requests and in response  
84           received 45 boxes of bates stamped paper documents as well as 175 GB  
85           of electronic material. Staff and the GCPI also conducted depositions.

86 The depositions were necessary, *inter alia*, because Staff wanted to clarify  
87 inconsistencies between the Company's responses to DRs and  
88 documents that it had turned over. Without depositions, Staff and the  
89 GCPI had a chance to directly question individuals about documents that  
90 they should have seen that would not have otherwise been available.

91 This additional discovery resulted in the retrieval of new information that  
92 not only supplements issues discussed in Staff's direct testimony but also  
93 identifies new issues. Since this is the first time the new issues will be  
94 addressed, my testimony is not merely replying to North Shore's rebuttal  
95 testimony but is introducing new issues, as would be found in direct  
96 testimony.

97 **Q: Did the material contain information about PEC's relationship with**  
98 **Enron beyond Staff's then current understanding?**

99 **A:** Yes. The material showed that the strategic partnership between the two  
100 corporate families went beyond enovate and the GPAA.

101 **Q: Why is the strategic partnership relevant to this proceeding?**

102 **A:** The extensive sharing between the two partners has several implications  
103 for the gas charge.

104 One, as discussed above, every transaction entered into between North  
105 Shore and Enron that resulted in profits generated profits for the holding  
106 company, PEC. As opposed to transactions with unaffiliated entities, any  
107 incremental profit from a higher price paid by the utility or a lower price

108 received by the utility benefits PEC. Thus North Shore has an incentive to  
109 buy at higher prices or sell at lower prices in deals with its strategic  
110 partner.

111 Two, since profits for the holding company due to North Shore  
112 transactions are only increased by deals with Enron, there is an increased  
113 incentive for North Shore to focus its attention on Enron. The harm in this  
114 behavior is two-fold. First, as noted above this directly pushes North  
115 Shore towards higher priced deals. Second, the Company may ignore  
116 opportunities to lower the gas charge or not raise it by failing to pursue  
117 trading opportunities with unaffiliated entities.

118 **Q: What is another area that the additional material altered Staff's**  
119 **perceptions concerning events during the reconciliation period?**

120 **A:** Prior to receiving the additional material, the Company refused to provide  
121 its study of the GPAA and its prudence for ratepayers. However, the  
122 additional material contained a study conducted about the GPAA (or a  
123 contract that was essentially similar) from two perspectives by Roy  
124 Rodriguez, an employee for Risk Management at PEC. Mr. Rodriguez  
125 called it the Aruba analysis. One aspect of the study looked at the net  
126 value that PEC was granting to Enron in the GPAA. The other examined  
127 the GPAA's effect on ratepayer gas costs. Below, I discuss the one  
128 aspect of the Aruba analysis in detail. While Staff repeatedly asked for  
129 this material, the company repeatedly refused to provide it.

130 **Q: Does profit sharing alter how Staff views transactions between PEC**  
131 **and Enron?**

132 **A:** Yes. Based on the close financial relationship between Enron and PEC it  
133 became apparent that transactions between Enron and PEC or Enron and  
134 North Shore should not be considered “arms-length” transactions.

135 **4. The GPAA.**

136 **4.A. Aruba analysis.**

137 **Q: What is the Aruba analysis?**

138 **A:** It is an economic analysis of the GPAA conducted by Roy Rodriguez, a  
139 Risk Management analyst employed by PEC.<sup>3</sup> Mr. Rodriguez described  
140 Risk Management’s role as \*\*\*BEG CONF [REDACTED]  
141 [REDACTED].” END CONF\*\*\* (Rodriguez deposition, p. 81)  
142 Apparently on his own initiative, he constructed a model to answer at least  
143 two questions. One, what is the economic value that the GPAA confers  
144 on Enron by PEC? Two, what effect does the GPAA have on the cost of  
145 gas paid by ratepayers?

146 **Q: What were his conclusions with respect to the second question?**

147 **A:** The cost of gas for ratepayers was higher under the GPAA than it would  
148 be absent the GPAA. \*\*\*BEG CONF

149 [REDACTED]  
150 [REDACTED]

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<sup>3</sup> The Aruba analysis is contained in an electronic file entitled *Economic Analysis Final.xls*.

151 [REDACTED]  
152 [REDACTED] <sup>4</sup> END CONF\*\*\*

153 **Q: Was another case present in the Aruba analysis?**

154 **A:** Yes. It showed a higher cost to ratepayers as well.

155 **Q: Please briefly describe your understanding of the model with respect**  
156 **to the second question?**

157 **A:** The model compares the two regimes (GPAA v. field zone purchases) to  
158 see which provides the lowest gas cost.

159 **Q: How does the Aruba analysis calculate the cost of gas under the**  
160 **GPAA?**

161 **A:** The cost of gas under the GPAA is the \*\*\*BEG CONF [REDACTED]  
162 [REDACTED]. END CONF\*\*\* The citygate price is  
163 computed as a forecast of the price at the Henry Hub<sup>5</sup> plus the forecasted  
164 price differential between the Henry Hub and Chicago.<sup>6</sup> NYMEX futures  
165 prices are used for the Henry Hub price through the third year of the  
166 contract. Thereafter, an escalation factor is used. The forecasted basis is  
167 the data attached to Mr. Wear's Direct Testimony as Exhibit 2. (The  
168 Company also provided it in response to ENG 2.92 Attachment D).

169 **Q: How is the cost of gas calculated under the non-GPAA?**

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<sup>4</sup> Deposition of Roy Rodriguez, p. 56.

<sup>5</sup> The principal delivery location for the New York Mercantile Exchange ("NYMEX") futures contract is the Henry Hub.

<sup>6</sup> This price differential is called the basis.

170 **A:** The cost of gas under the non-GPAA is the cost of gas in the field plus the  
171 cost of variable transportation to Chicago. The price in the field, by  
172 location, is forecasted as the NYMEX price plus the forecasted basis  
173 (using the same source as in the citygate price calculation) between that  
174 location and the Henry Hub. Variable transportation (including fuel) is  
175 determined using pipeline tariffs.

176 **Q:** **How did the Aruba analysis estimate the effects of the GPAA besides**  
177 **comparing the field delivered price to the citygate price less the**  
178 **discount?**

179 **A:** It did not consider any other terms. All the other terms (for example, the  
180 Summer Incremental Quantity ("SIQ")) lead to higher prices for the  
181 ratepayer. If the GPAA does not provide lower gas prices (including the  
182 discount) than the alternatives, it is very difficult to believe that the GPAA  
183 would result in lower costs for ratepayers than the non-GPAA case.

184 **Q:** **Did the decision makers see this analysis?**

185 **A:** Mr. Rodriguez claims that he presented his results to mid level employees  
186 of North Shore, but it is not clear whether Mr. Morrow or Mr. Patrick  
187 received this study.<sup>7</sup>

188 **Q.** **To determine the prudence of entering into the GPAA, does it matter**  
189 **if Company decision makers were aware of the Aruba analysis?**

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<sup>7</sup> Deposition of Roy Rodriguez, p. 76-78.

190 A. Only as a matter of degree. If decision makers were not aware of the  
191 analysis, then Staff continues to hold that it was imprudent to sign the  
192 GPAA without a study that was substantially similar to the Aruba analysis  
193 (but with a positive result, obviously). It would have been even more  
194 imprudent for the Company to enter into the GPAA with their best analysis  
195 showing it was a losing proposition for ratepayers. If decision makers  
196 were aware of Mr. Rodriguez's Aruba analysis (and its negative results),  
197 then they should have either abandoned the GPAA or at least given it a  
198 second look with some other competing detailed analysis.

199 **Q: Do you know why the GPAA was signed in spite of the results from**  
200 **the Aruba analysis?**

201 **A:** No. But three things are apparent. PEC signed the 1999 Letter of Intent  
202 and so was intent upon forming a strategic partnership with Enron. The  
203 GPAA was apparently one way it could cement that partnership. If so,  
204 North Shore's leadership team may have discounted the study's results in  
205 order to justify the contract. Related to this, North Shore may have  
206 believed that the study had serious flaws that limited its usefulness.  
207 However, the Company has not elaborated on any aspect of the Aruba  
208 analysis to expose any flaws that may be present. In addition, if the flaws  
209 were serious enough to significantly undercut the Aruba analysis, Staff  
210 believes that the Company should have devoted resources to improve the  
211 study's reliability. Instead, the Company treats the analysis as some  
212 foreign and almost invisible thing.

213 **4.B. GPAA evaluation.**

214 **Q: What is the Company's position on whether the GPAA can be**  
215 **evaluated as a sum of its parts?**

216 **A:** Company witness Wear thinks evaluating the GPAA by valuing each  
217 individual contract element and summing the values is simplistic.

218 **Q: Should the GPAA be evaluated as the sum of its parts?**

219 **A:** Yes. The GPAA is a complex agreement. It has some elements that lead  
220 to lower costs for ratepayers relative to the alternatives (e.g., avoidance of  
221 demand charges) and some that raise costs (e.g., the SIQ term). The  
222 decision to sign the GPAA was one decision, not a series of decisions to  
223 sign each individual contract element. Thus, Staff considered the contract  
224 as a whole in its analysis of prudence. However, the only sensible way to  
225 evaluate the contract as a whole is to first value each element of the  
226 complex contract and then sum those values to arrive at the contract's  
227 total net benefit. Theoretically, if there were ways that individual elements  
228 of the contract interacted that enhance or degrade other elements, those  
229 interaction effects should be evaluated as well. However, I did not  
230 perceive any interactions between the provisions of the GPAA in my  
231 study.

232 **Q: In his Rebuttal Testimony, Mr. Wear asserts that there are "non-**  
233 **quantifiable benefits" not tied to a specific GPAA element. What are**  
234 **the 'non-quantifiable benefits'?**

235 **A:** Mr. Wear's rebuttal testimony identifies three non-quantifiable benefits in  
236 the GPAA. One, the contract is a single supplier contract for a large  
237 percentage of demand, therefore the GPAA allows the Company to hide  
238 its position in the market from other traders. Two, the agreement allows  
239 itself to be "completely re-opened" upon the instigation of a PBR. Three,  
240 Enron was the pre-eminent/dominant supplier at the time: having Enron as  
241 its supplier enhanced the North Shore's supply reliability.

242 **Q: Are these benefits non-quantifiable?**

243 **A:** No. They may have qualities that are not directly evaluated in a market,  
244 but that does mean that they are not quantifiable. My view is that if an  
245 alleged benefit of the contract is not quantifiable, then that benefit is either  
246 chimerical or has a minimal value. In any event, the Company presents no  
247 credible evidence to show that these previously unmentioned "non-  
248 quantifiable" benefits that somehow outweigh the costs clearly identified  
249 by Staff.

250 **Q: Please respond to the first non-quantifiable benefit?**

251 **A:** The Company does not explain how such anonymity in the market  
252 translates into a benefit (quantifiable or unquantifiable). Perhaps the  
253 Company's theory is that this anonymity somehow enables the utility,  
254 indirectly through Enron, to buy gas on the spot market at a lower price, or  
255 to sell gas on the spot market at a higher price. If that is the Company's  
256 intent, the plan is destined to fail because other traders would still notice

257 Enron's increase in demand or supply to support the trades for Peoples.  
258 Market prices would react the same to Enron demand and supply as it  
259 would to North Shore's demand and supply. Because of this, it is no  
260 wonder that the Company claims this is an unquantifiable benefit. That is,  
261 the dollar value of the "benefit" may simply be materially indistinguishable  
262 from zero.

263 **Q: Please respond to the second non-quantifiable benefit?**

264 **A:** This issue is very similar to another benefit alleged by North Shore in its  
265 additional direct testimony. I also addressed in my direct testimony, where  
266 I noted that the pricing flexibility in Article 4a of the GPAA is not a  
267 significant benefit for ratepayers, since Enron NA is only likely to agree to  
268 alterations that provide it an equal value or better. I also noted that any  
269 benefit from flexible pricing is due only to the long, five-year term of the  
270 GPAA. Shorter-term contracts would run out before prices should or need  
271 to be re-contracted.

272 **Q: Please respond to the third non-quantifiable benefit?**

273 **A:** Supply reliability certainly has value. However, the Company offered no  
274 evidence that Enron was a more reliable supplier than other alternatives; it  
275 did not examine the extent of that differential, and it did not show what that  
276 differential would have been worth.

277 **Q: What changes did you make in you empirical evaluation of the**  
278 **GPAA?**

279 **A:** I have made several changes to improve the accuracy of the calculations  
280 and highlight the most important factors besides fixing simple  
281 computational errors.<sup>8</sup> One, based in part on the Aruba analysis, various  
282 price indexes-basis forecasts are realigned with delivery points on the  
283 interstate pipelines that are released to Enron NA as part of the GPAA.  
284 That realignment carries forward to the calculation of the disallowance.  
285 Two, the comparison between basis and transport costs is re-configured  
286 as a comparison between field gas transported to the citygate versus gas  
287 purchased at the citygate. Three, the calculation for SIQ and re-pricing  
288 volumes is simplified. Four, alternative cases are provided for the SIQ  
289 and re-pricing calculations to highlight that even if ridiculously low daily-  
290 monthly differentials are assumed, the GPAA remains imprudent because  
291 the delivered-citygate price comparison remains so unfavorable to  
292 ratepayers.

293 **Q: Which elements of the empirical evaluation are not changed?**

294 **A:** The general method remains the same. An update to the Appendix is  
295 attached to my testimony to show the changes. Aside from corrections of  
296 calculation errors and the changes mentioned above, there are no other  
297 changes.

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<sup>8</sup> In my Direct Testimony, the wrong volumes (baseload and total SIQ) were used. Baseload and minimum SIQ should have been used to evaluate the GPAA and in calculating the disallowance. Substituting the correct quantity tends to make the GPAA look more favorable and reduce the disallowance.

298 **Q: What is the most important part in your empirical evaluation of the**  
299 **GPAA?**

300 **A:** The most important comparison in the evaluation is that between cost of  
301 gas purchased in the field and transported to the citygate versus the cost  
302 of gas purchased at the citygate. The Company stated that the GPAA  
303 served as a hedge against a declining basis. To 'purchase' that hedge, it  
304 agreed to several other terms that clearly raise prices for ratepayers.  
305 Thus, if it costs more to buy citygate gas than it does to buy gas in the  
306 field and transport it to the citygate, then the GPAA cannot be prudent. I  
307 continue to use the basis projections provided by the Company in  
308 discovery and in testimony to evaluate the GPAA. And I do not examine  
309 the CERA cases within the context of this evaluation to see what happens.  
310 As I noted previously, the Company does not claim to have used the  
311 CERA study to investigate whether to sign the GPAA.

312 In his Rebuttal Testimony, Mr. Graves provided further information about  
313 several scenarios that projected bases that provide a more favorable  
314 comparison for the GPAA. (See Cambridge Energy Research Associates  
315 *At the Crossroads of Competition: The Future of Midwest Gas and Power*  
316 *Markets*, Final Report Winter 1999 ("CERA report") discussed in Mr.  
317 Graves Rebuttal Testimony and eventually provided in response to POL  
318 11.2) While some scenarios presented therein have data that appears to  
319 show that the GPAA was a good choice, the Company does not document  
320 that it had actually considered that data when deciding to negotiate and

321 sign the GPAA. (See the Company's response to POL 11.10) Providing  
322 this study in rebuttal testimony is simply after the fact justification rather  
323 than a demonstration that the Company acted prudently. In its response  
324 to POL 11.11, the Company notes that it did not estimate relative  
325 probabilities of the different scenarios. The CERA study itself provided no  
326 probabilities for the various scenarios that it presents. In its response to  
327 POL 11.8, North Shore states that, "This study [referring to the CERA  
328 report] merely exemplified the information that the Company gave  
329 consideration to as support for its decision to enter into the GPAA." The  
330 Aruba analysis done by Roy Rodriguez, however, uses the exact same  
331 basis data that Mr. Wear used in his exhibits and that the Company  
332 provided in discovery.

333 **a. Delivered prices versus citygate prices.**

334 **Q: Does Staff believe that the Company is obligated to pick the best**  
335 **alternative for ratepayers given the information and its evaluation of**  
336 **the alternatives?**

337 **A:** Staff used discovery to understand what the Company believed its  
338 alternatives were and how it evaluated those alternatives with respect to  
339 the ratepayers. The Company typically makes very general statements  
340 about the facts and reasoning that justify its decisions. For example,  
341 when it tries to justify the GPAA, it claims that the contract enabled it to  
342 hedge against a declining basis. The data that the Company provided in

343 the Direct Testimony of David Wear and in discovery, did forecast a  
344 declining basis. However, the initial basis was not small enough and/or it  
345 did not decline fast enough to establish that the GPAA was a better option  
346 than its previous purchasing practices. Moreover, it did not consider what  
347 would have resulted had it continued those practices.

348 **Q: With respect to changes in the basis differential, Mr. Wear,**  
349 **differentiates between expectations and projections. In effect, he**  
350 **argues that the GPAA was designed to enable the Company to hedge**  
351 **against more extreme projections of the basis differential than were**  
352 **expected. How do you respond to this position?**

353 A: While it is sensible to consider the potential effect of more extreme  
354 conditions than expected, it is not sensible to commit large sums of money  
355 to hedge against extremely low-probability events. Mr. Wear claims that  
356 the Company projected the possibility for large drops in the basis, but the  
357 Company made no attempt to assess the likelihood of those large drops  
358 ever occurring. Indeed, Mr. Wear argues that the Company is under no  
359 obligation to formally analyze such projections. Mr. Wear is apparently  
360 claiming that any individual can project or imagine the possibility for any  
361 particular outcome, and use that to try to convince others that some action  
362 needs to be taken. But it is my view that actions--in particular, the  
363 Company's decision to sign the GPAA--cannot be shown to be prudent  
364 unless the Company can demonstrate through documentary evidence  
365 about how it viewed the relative probabilities of different events.

366 **Q: In its Direct Testimony, what did Staff assume was the Company's**  
367 **estimate of the basis in the future?**

368 **A:** Staff relied upon the price information that was provided to it by the  
369 Company. The Company provided one set of basis projections in its  
370 additional direct and in discovery prior to filing rebuttal. I proceeded with  
371 the data that I believed that the Company explicitly considered in its  
372 purchase decisions. However, in rebuttal testimony, Mr. Graves  
373 extensively analyzed another set of basis projections. There were two  
374 sources. One was CERA, and Mr. Graves also considers something from  
375 PIRA Energy Group ("PIRA").

376 **Q: Did the Company possess the CERA report prior to signing the**  
377 **GPAA?**

378 **A:** It apparently received the report in the fourth quarter of 1998, but it is not  
379 documented. (See Company's response to POL 12.1)

380 **Q: What part did the CERA report play in its negotiations with Enron for**  
381 **the GPAA?**

382 **A:** In POL 11.8 Staff asked, "Why did the Company not provide the results  
383 and data from the CERA study referenced in Mr. Graves' Rebuttal  
384 Testimony in Mr. Wear's Additional Direct Testimony if it played a part in  
385 the decision to enter into and the negotiations for the Enron North America  
386 GPAA?" The Company replied in part that,

387 "It [the CERA report] quantifies the projected potential impacts of the  
388 thinking at that time that supports his independent opinion that the

389 contract was prudent. Mr. Graves' specific analysis derived from the  
390 CERA study was not used to support Respondent's decision to enter  
391 into the GPAA as it was not available when the negotiations were  
392 ongoing."

393 Since Staff did not ask about Mr. Graves' analysis, this response is  
394 somewhat puzzling. But, it appears that the CERA report played no part  
395 in the negotiations with Enron as noted above (see Company response to  
396 POL 11.10 and POL 11.11.

397 **Q: Are the CERA report numbers directly comparable with the ENG 2.92**  
398 **Attachment D numbers?**

399 **A:** No. The CERA numbers reflect calendar year annual data, while the ENG  
400 2.92 Attachment D numbers reflect monthly data. Thus, while the ENG  
401 2.92 Attachment D numbers can easily be assimilated into an analysis of  
402 the Peoples fiscal year (October through September), the CERA numbers  
403 cannot. A comparison on an aggregated level is thus difficult to do, since  
404 the annual bases presented in my testimony is done for a fiscal year.  
405 Finally, the annual figures in my direct testimony use expected GPAA  
406 volumes as weights, while it appears that the CERA data is unweighted.  
407 The importance of an unweighted versus weighted averages is that  
408 heavier volumes in the heating season with a higher basis pull the  
409 weighted average higher than the unweighted version. For example, the  
410 unweighted average bases in ENG 2.92, Attachment D are \*\*\*BEG CONF  
411 [REDACTED], END CONF\*\*\* while the weighted averages for that same data  
412 range from \*\*\*BEG CONF [REDACTED], END CONF\*\*\* Thus, if CERA  
413 numbers are unweighted (by volumes over the year) bases, then CERA

414 need to be adjusted upward to more directly compare with the numbers  
415 from ENG 2.92 Attachment D.

416 **b. Foregone demand credit.**

417 **Q: What is the Company's position on your estimate of foregone**  
418 **demand credits?**

419 **A:** The Company asserts that it is problematic to reliably estimate this factor.  
420 Mr. Wear argues that. North Shore witness Mr. Wear uses the term  
421 "ostensible precision" to discredit the dollar values estimated in my direct  
422 testimony. Mr. Wear also attempts to discredit the estimate by  
423 characterizing it as using unrelated pieces of information.

424 **Q. Are Mr. Wear's comments correct?**

425 **A.** No they are not.

426 **Q: Please explain why not.**

427 **A:** The estimation method I used is reasonable. It employs the actual  
428 demand credits for fiscal year 1999, the year prior to the beginning of the  
429 GPAA, as an estimate of the demand credits at risk. It then reduces that  
430 number over the term of the GPAA reflecting the reduction in the pipeline  
431 capacity released to Enron NA. I also account for a \*\*\*BEG CONF xxxx  
432 xxxx END CONF\*\*\* per year reduction in the demand credit margins that  
433 is consistent with the Company's previously expressed projection for the  
434 rate of decline in the basis. I note that North Shore does not offer a  
435 number in reply, but just criticizes my estimate. It cannot be denied that

436 the GPAA reduces potential demand credits. And those demand credits  
437 are not available to flow through the PGA after North Shore signed the  
438 GPAA. I attempted to estimate this important effect of the GPAA, while  
439 the Company dismisses it out of hand. Finally, while I continue to support  
440 this part of the analysis, it does not drive the evaluation results. See  
441 Exhibit 7.01.

442 **Q: Are you changing your estimate for the value of foregone demand**  
443 **credits?**

444 **A:** No.

445 **c. Repricing Options.**

446 **Q: What did the Company say in its rebuttal about your estimate of the**  
447 **value of the repricing terms?**

448 **A:** The Company stated that Staff's analyses of Articles 4.2b and 4.2c of the  
449 GPAA are not valid. Mr. Wear argues that it is invalid to use historical  
450 data to project the \*\*\*BEG CONF [REDACTED]  
451 [REDACTED] END CONF\*\*\* that are referenced  
452 in the contract in relation to this differential.

453 **Q: Does the Staff assert that the past is a perfect guide for the future?**

454 **A:** No, the future should not be expected to perfectly mirror the past.  
455 However, I believe the past can be a reasonable guide with respect to the  
456 estimating the average positive differential between daily and the first-of-

457 the-month price indices, which is needed to evaluate Articles 4.2b and  
458 4.2c of the GPAA.

459 **Q. Why was it necessary to have a projection of the \*\*\*BEG CONF**  
460 **XX**  
461 **XXXXXXXXXX, END CONF\*\*\* in order to evaluate Articles 4.2b and 4.2c**  
462 **of the GPAA?**

463 A. As discussed in my direct testimony, Articles 4.2b and 4.2c enabled  
464 Enron, to switch the prices of fixed quantities of its gas sales to North  
465 Shore from a \*\*\*BEGIN CONF XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX  
466 XXX  
467 XXXXX. END CONF\*\*\* It could do this whenever it was to Enron's financial  
468 advantage. In essence, these provisions amounted to the granting of a  
469 special type of Put option. One reasonable way to value this implicit Put  
470 option was to \*\*\*BEGIN CONF XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX  
471 XXX  
472 XXX  
473 XXX  
474 XXX. END CONF\*\*\* Since  
475 Enron can always determine when the \*\*\*BEGIN CONF XXXXXXXXXXXXXXXXXXXXXXX  
476 XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX, END CONF\*\*\* it is reasonable to  
477 assume that Enron would be rational by always exercising the option  
478 under such conditions.

479 **Q. How does the Company suggest that the implicit Put option should**  
480 **have been valued?**

481 A. Inexplicably, the Company offers no alternative to the method that I used  
482 in my direct testimony. If the Company believed the past is a poor guide  
483 to the future, as Mr. Wear argues, then presumably the Company could  
484 have offered some other means of projecting the \*\*\*BEGIN CONF [REDACTED]  
485 [REDACTED]  
486 [REDACTED], END CONF\*\*\* or it could have produced some completely  
487 different way of valuing the Put option implicit in Articles 4.2b and c that  
488 does not depend on an estimate of that differential. Knowing of no other  
489 more reliable means, given the data available, the Staff used the common  
490 statistical approach of basing forecasts upon historical data.

491 Q: Did you make an error when calculating the \*\*\*BEGIN CONF xxxxxxxx

492 xx

493 END CONF\*\*\* during the Winter Period?

494 **A:** Yes, I used an incorrect set of months for the Winter Period. In my  
495 revised attachments, I correct the mistake. It tends to lower the estimate  
496 for the net GPAA cost, but the effect is relatively small. The revised  
497 evaluation differs from the original due to several changes, and I do not  
498 determine the effect from this one change.

499 **Q: What new information came to light in the additional discovery**  
500 **concerning Section 4.2b?**

501 **A:** In paper documents after February 2004, there is a letter from David  
502 Delaine (the President of Enron North America, who signed the GPAA for  
503 Enron) to Peoples Energy (no individual listed) that provides Enron's  
504 valuation of Article 4.2b.<sup>9</sup> That letter valued Article 4.2b for Enron NA at  
505 \*\*\*BEGIN CONF [REDACTED] END CONF\*\*\* The letter stated that,  
506 \*\*\*BEGIN CONF "[REDACTED]  
507 [REDACTED]  
508 [REDACTED]" END CONF\*\*\*

509 **Q:** How did the value in the Delaine letter compare to Staff's a priori  
510 estimate?

511 **A:** I estimate the value of this element of the GPAA at approximately  
512 \*\*\*BEGIN CONF [REDACTED] END CONF\*\*\* over the five years of the  
513 contract.<sup>10</sup> The difference between Delaine's \*\*\*BEGIN CONF [REDACTED]  
514 END CONF\*\*\* and my estimate could reflect expectations of greater  
515 volatility than had occurred in the recent historical period that I relied upon  
516 in my calculations. The greater the expected volatility during the life of the  
517 contract, the greater is the expected value of the implicit Put option  
518 embedded in Article 4.2b.

519 **Q:** Can you use the Delaine letter to form an equivalent Enron NA  
520 estimate for Article 4.2c?

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<sup>9</sup> The Bates number is 01PGL 053562.

<sup>10</sup> See Exhibit 7.01.

521 **A:** Yes. I calculate the value per MMBtu implicit in the Delainey letter figure  
522 and apply that value to the volumes in the Article 4.2c term. Using this  
523 method provides estimate of approximately \*\*\* BEGIN CONF \$xxxxxx. END  
524 CONF\*\*\*

525 **d. Resale penalty.**

526 **Q: What is the resale penalty in the GPAA?**

527 **A:** North Shore has the right to re-sell gas back to Enron (see Article 2.4)  
528 based upon the daily index minus a penalty, which depends upon the size  
529 of the resale and when the resale was nominated (see Article 4.1e). North  
530 Shore accepts a discount off the midpoint to ensure that its excess  
531 purchases can be cleared.

532 **Q: How does the Company criticize Staff's evaluation of the resale**  
533 **penalty?**

534 **A:** The Company makes three criticisms of Staff's estimates of the resale  
535 penalty. One, it says I incorrectly assume that sellers can always find  
536 buyers at the daily midpoint price. (Wear Rebuttal, lines 358-379) Two, it  
537 says that I improperly ignore the effect that timing can have on price.  
538 (Wear Rebuttal, lines 380-388) Three, it says that I incorrectly assume, at  
539 least implicitly, that volume has no effect on price. (Wear Rebuttal, lines  
540 389-401) In general, the Company alleges that the resale term is  
541 beneficial within the context of the GPAA.

542 **Q: How do you respond to these points?**

543    **A:**    The issue revolves around the nature of the citygate index price. It is  
544           either a good representation of the price available on a given day or it  
545           isn't. If the latter case is true, the Company should not rely upon this  
546           same index when pricing out quantities under the GPAA or other  
547           contracts. The exact same principle also applies to the monthly price for  
548           baseload and SIQ. The 'discount' that the GPAA provides isn't real if the  
549           index does not represent a fair approximation for the gas price. While it  
550           may be true that the price varies during the day and dumping higher  
551           volumes of gas on a given day should tend to depress price, all else  
552           equal, it does not follow that the index is not a good (or at least the best)  
553           approximation of the price on a given day. Of course not all trades are  
554           done at the daily midpoint. What is important is whether the midpoint  
555           provides a reasonable method to assess what occurs in the market. If it  
556           does not, then it should not be used in the GPAA at all.

557           Further, to the extent that the excess gas was delivered to the citygate,  
558           the effect of the sellbacks on the price of gas is not mitigated. Enron NA  
559           had to dispose of the gas, presumably by selling it and putting downward  
560           pressure on the market price. The effect of actual deliveries to Chicago is  
561           particularly true in the context of the GPAA. The Company makes excess  
562           purchases under the SIQ term, and since the Company does not control  
563           those volumes, some of it is likely to exceed its current needs. Further,  
564           the GPAA specified baseload quantities for North Shore over a five-year  
565           term. Absent the GPAA, the Company would not be locked-in to

566 purchases at fixed volumes. That is what makes the resale provision  
567 valuable. North Shore's contracting process should only lead to excess  
568 purchases occasionally and in small quantities. That is simply not the  
569 case under the GPAA's SIQ provision. I conclude that the daily price  
570 represents a reasonable alternative for estimating the value of that gas.

571 **Q: Do you change your estimate of the resale penalty?**

572 **A:** No.

573 **e. SIQ option.**

574 **Q: How does North Shore justify the SIQ provision?**

575 **A:** Mr. Wear states that the pricing mechanism is appropriate since it is a put  
576 option sale to Enron NA in exchange for a discount. Further, the  
577 Company intended these quantities to be used for storage refill. Mr. Wear  
578 states, "This is particularly true for storage refill programs where the buyer  
579 is not specifically concerned with which days storage is injected, and is  
580 willing to accept a varying amount of deliveries from day to day." (Wear  
581 Rebuttal at lines 661-664)

582 **Q: Is the SIQ provision imprudent?**

583 **A:** I did not evaluate the SIQ provision independently, and the SIQ illustrates  
584 the problem of evaluating the GPAA well. By itself, the SIQ could not be  
585 prudent. However, Staff's position is that the GPAA must be evaluated as  
586 a whole. Thus, in my direct testimony, I balanced the "negative," such as  
587 the SIQ provision, against the "positive," such as the discount. Only by

588 examining each provision and netting them all against each other can the  
589 decision to enter into the GPAA be deemed prudent or imprudent.

590 **Q: How does North Shore respond to Staff's estimate of the SIQ's**  
591 **value?**

592 **A:** The Company does not believe that a daily-monthly price comparison is  
593 valid. In a way, the SIQ is kind of a mirror image of the repricing terms.  
594 Both allow Enron to choose to sell up to a certain volume each day to  
595 North Shore at a price higher than either is specified in the GPAA or would  
596 be allowed by the GPAA. To see this note that in the repricing terms,  
597 Enron can unilaterally opt for a higher price by day during the Summer  
598 Period. And during the Summer Period when the SIQ is in effect, there is  
599 usually plenty of slack in the released pipeline capacities for North Shore  
600 to choose the DIQ for at least as much volumes (and at times more) than  
601 is specified in the SIQ. Thus, Enron again can force North Shore to pay  
602 higher prices than it would have to as specified in the contract. For the  
603 same reasons that using historical data to estimate pricing differentials in  
604 estimating the costs of the repricing terms, it is just as valid in the case of  
605 the SIQ. I also note that North Shore again refused its opportunity to  
606 provide an alternative value for the SIQ in this docket based upon  
607 whatever data and analysis it sees fit.

608 **Q: Did the Aruba analysis assume a price for the SIQ?**

609 **A:** Yes. It estimated that the put option was worth \*\*\*BEGIN CONF ~~xxx~~¢ END  
610 CONF\*\*\* per MMBtu. Over the five-year term of the agreement, the SIQ  
611 totaled \*\*\* BEGIN CONF \$~~xxxxxxxxxx~~ END CONF\*\*\* of non-discounted  
612 dollars. I estimated that the cost to the ratepayers was \*\*\*BEGIN CONF  
613 \$~~xxxxxxxxxx~~. END CONF\*\*\*

614 **Q: Please summarize the results of your forward-looking evaluation of**  
615 **the GPAA.**

616 **A:** The comparison remains unfavorable. I estimate that the expected  
617 additional gas cost to ratepayers stemming from the GPAA is  
618 approximately \$37.6 million in non-present value terms. See Exhibit 7.02

619 **4.C. Disallowance recalculation.**

620 **Q: What changes did you make in you disallowance calculation for the**  
621 **GPAA?**

622 **A:** The changes to the disallowance calculation parallel the changes to the  
623 prudence evaluation besides simple computational errors. One, various  
624 price indexes-basis price levels are realigned with delivery points on the  
625 interstate pipelines that are released to Enron NA as part of the GPAA.  
626 Two, the comparison between basis and transport costs is re-configured  
627 as a comparison between field gas transported to the citygate versus gas  
628 bought at the citygate.

629 **Q: Please summarize the results of Staff's GPAA disallowance**  
630 **recalculation.**

631 **A:** The re-calculation yields a disallowance for the imprudent contract of  
632 \$1,713,720. See Exhibit 7.04 attached to my testimony.

633 **5. Manlove field usage.**

634 **Q:** Did North Shore respond to Staff's assertion that the Company's use  
635 of Manlove field during December 2000 was imprudent?

636 **A:** No.

637 **Q:** On net, did North Shore withdraw gas for ratepayers during  
638 December 2000?

639 **A:** No.

640 **Q:** Did North Shore's storage plan call for withdrawals for ratepayers  
641 during December 2000?

642 **A:** Yes. Staff Witness Dennis Anderson in his Additional Direct and Rebuttal  
643 Testimony details North Shore's storage plan and its usage during  
644 December 2000.

645 **Q:** Was North Shore imprudent when it did not withdraw gas during  
646 December 2000?

647 **A:** Yes. I agree with Mr. Anderson that this behavior was imprudent.

648 **Q:** How does Staff calculate the disallowance for imprudent storage  
649 usage?

650 **A:** The effects on gas costs from North Shore imprudent storage usage is the  
651 additional cost stemming from the gas that North Shore had to buy to  
652 make up the storage shortfall less the cost of the stored gas.

653 **Q: What are the estimated costs to ratepayers of North Shore's**  
654 **practices?**

655 **A:** I estimate that \$2,249,249 in additional costs were imposed on ratepayers  
656 by North Shore's failure to fully use Manlove storage to their benefit. See  
657 Exhibit 7.05.

658 **Q: Please outline how you calculate the disallowance for imprudent**  
659 **storage usage?**

660 **A:** I examined the gas purchases that North Shore made in December 2000  
661 and January 2001. The data source is the Company's response to POL  
662 1.49. The highest cost gas purchases on each day are reversed in these  
663 two months (i.e., the costs are taken out of the PGA). At the same time,  
664 those reversed volumes are replaced with gas from Manlove field. The  
665 difference in cost between the two sources of gas is the recommended  
666 disallowance. For example, suppose on a given day, North Shore buys  
667 \$10 per MMBtu gas when it could have used stored gas valued at \$6.23  
668 per MMBtu (the cost of the reconciliation period's LIFO layer). I would  
669 calculate the disallowance for those volumes as \$3.77 per MMBtu.

670 Exhibit 7.06 presents the disallowances calculated for imprudent storage  
671 as well as for off-system sales Transaction 19, Transaction 16 and 22 and  
672 Transaction 103.

673 **Q: Why is it appropriate to use the highest priced gas each day to value**  
674 **the adjustment?**

675 **A:** North Shore is presumably able to determine the highest cost gas at any  
676 given time. The full cost imposed upon ratepayers is determined by  
677 subtracting the highest cost gas.

678 **Q: What is the next step?**

679 **A:** The purchases that are reversed must be selected and their total costs  
680 calculated. The considerations that enter this aspect of the calculation are  
681 the price paid for those volumes, the amount of those purchases and the  
682 price of gas in storage. One limitation is the volume of purchases. If the  
683 amount brought out of storage is more than the additional volumes that  
684 North Shore bought (rather than use storage), the amount of storage  
685 interrupted for third parties is the additional volumes purchased. For  
686 example, if there are 100 MMBtus of additional purchases and 200  
687 MMBtus are delivered from Manlove field for third parties, my  
688 disallowance calculation reverses only 100 MMBtus of additional  
689 purchases.

690 Another limitation is the price paid for the replacement gas. If the price of  
691 replacement gas is below \$6.23, then it does not affect the calculations.

692 The \$6.23 price is the weighted average cost of gas for the entire fiscal  
693 year (the LIFO cost). This price is the reason that December 2000 and  
694 January 2001 are the only months that figure in the disallowance  
695 calculations.

696 **Q: After you determined which purchases are to be reversed, what is**  
697 **the next stage?**

698 **A:** The highest priced purchases are identified and their costs summed. The  
699 total cost for the highest priced purchases is the expenditures reduced by  
700 curtailing third party activity at Manlove field.

701 Since the calculation posits that North Shore should have used Manlove  
702 more intensely for ratepayers during December 2000 and January 2001,  
703 those volumes must have a cost assigned to them. The fiscal year's  
704 weighted average cost of gas (LIFO layer) equal to \$6.23 is used. That is,  
705 the reduced cost from subtracting purchases is offset by the cost of gas in  
706 storage, which is estimated by the overall average cost of gas for the year.

707 **6. Management Audit.**

708 **Q: Is Staff recommending that the Commission order North Shore to**  
709 **undergo a management audit?**

710 **A:** Yes. See the Direct Testimony of Staff witnesses Knepler and Anderson  
711 as well as their Additional Direct and Rebuttal Testimonies (Dianna?) and

712 Rearden's Direct Testimony for a discussion of various matters that  
713 support Staff's recommendation. I reinforce that analysis here.

714 **Q: What are the broad concerns that Staff has with North Shore that call**  
715 **for a management audit?**

716 **A:** I believe that the Company lacked the internal controls to prevent the  
717 abuses that I have observed. For example, Manlove field was  
718 underallocated to ratepayers during the fiscal year's heating season.  
719 Various deals and transactions seem to have been done with an  
720 insufficient, if any, attention being paid to their effect's upon ratepayers.  
721 For example, the GPAA was signed without an empirical investigation to  
722 identify its effect on the PGA.

723 Contributing to the lack of internal controls is the lack of documentation for  
724 decisions that affect the PGA. Most egregiously, either no study by  
725 Peoples was conducted to evaluate the GPAA or the study that was  
726 conducted at PEC was ignored. Mr. Morrow counted upon his staff to tell  
727 him that the GPAA delivered reasonable gas costs, but his staff now  
728 states that they did not have any input into the prices in the contract.

729 The strategic partnership with Enron NA had no documentation that the  
730 Company can or will produce that discussed its effects upon utility  
731 operations. In that partnership, many deals were done that flowed some  
732 revenues through the PGA. The Company cannot now produce  
733 documents or explain those revenue allocations.

734 Like the decision to sign the GPAA, the SOC was signed without any  
735 economic study or analysis. Similarly, North Shore cannot produce  
736 studies explaining why the SOC was the best alternative available to it.

737 **7. Hedging.**

738 **Q: Do you support a disallowance because the Company did not**  
739 **sufficiently hedge its purchases during the fiscal year's heating**  
740 **season?**

741 **A:** No.

742 **Q: Why do you conclude that the Company was not imprudent for**  
743 **failing to hedge more than it did?**

744 **A:** Hedging is a way to reduce the price volatility. It does not generate  
745 inherently better prices than speculating. That is, it does not necessarily  
746 provide lower expected gas prices. Since hedging does not always lower  
747 prices, it can only really be evaluated with respect to the appetite for risk  
748 that consumers have. PGA customers may not spend enough of their  
749 overall budget on natural gas to generate strong demand for hedging.  
750 That is, consumers well-being may not be optimized by hedging programs,  
751 even if they produce lower costs in a given year, ex post.

752 That is, the hedging disallowance is not due to the Company engaging in  
753 lackadaisical competitive bidding practices, unnecessarily incurring  
754 pipeline imbalance penalties, or doing something else that could only  
755 increase costs for ratepayers unnecessarily.

756 **Q: Can those who advocate a disallowance for hedging estimate a year**  
757 **in and year out savings from this practice?**

758 **A:** No. This year, the utility lost when it did not hedge. Next year, it could  
759 “lose” again by hedging. In other words, there are inherent risks as to  
760 whether the Company will reduce or increase net gas costs through  
761 hedging. If prices were predictable or even their volatility was predictable,  
762 then futures prices would reflect that predictability and hedging would hold  
763 few benefits.

764 **Q: Does this conclude your additional direct/rebuttal testimony?**

765 **A:** Yes.

**APPENDIX**

\*\*\*BEG CONF





END CONF\*\*\*